EXHIBIT 3

networkengines

NETWORK ENGINES INC (NENG)

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CANTON, MA 02021
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10–K

FORM 10–K
Filed on 12/20/2002 – Period: 09/30/2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10–K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended September 30, 2002

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number: 0–30863

NETWORK ENGINES, INC.
(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation)**	**04–3064173** **(I.R.S. Employer Identification No.)**
25 Dan Road, Canton, MA **(Address of principal executive offices)**	**02021** **(Zip Code)**

Registrant's telephone number, including area code (781) 332–1000

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, $0.01 par value

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period than the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [_]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S–K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statement incorporated by reference in part III of this Form 10–K or any amendment to this Form 10–K. [X]

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b–2). Yes [ ] No [X]

The aggregate market value of the voting Common Stock held by non–affiliates of the registrant on November 29, 2002 was approximately $14,492,319.

The number of shares outstanding of the registrant's Common Stock as of November 29, 2002: 30,534,700 shares.

Documents incorporated by reference:

Portions of the registrant's definitive Proxy Statement for its Annual Meeting of Stockholders for the year ended September 30, 2002, which will be filed with the Securities and Exchange Commission within 120 days after the end of the Company's fiscal year, are incorporated by reference into Part III hereof.

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NETWORK ENGINES, INC.
ANNUAL REPORT ON FORM 10–K
For the Fiscal Year Ended September 30, 2002

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This Form 10–K contains forward–looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties. All statements other than statements of historical information provided herein are forward–looking statements and may contain projections relating to financial results, economic conditions, trends and known uncertainties. Our actual results could differ materially from those discussed in the forward–looking statements as a result of a number of factors, including the factors discussed in this section and elsewhere in this report and the risks discussed in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward–looking statements, which reflect management's analysis, judgment, belief or expectation only as of the date hereof. We undertake no obligation to publicly reissue these forward–looking statements to reflect events or circumstances that arise after the date hereof.

PART I

ITEM 1. BUSINESS

Description of Business

Network Engines, Inc. ("Network Engines or the "Company") is a provider of server appliance hardware and custom integration services. Server appliances are pre–configured network infrastructure devices designed to deliver specific application functionality. We are focused on partnering with independent software vendors ("ISVs") and original equipment manufacturers ("OEMs") to provide these strategic partners with server appliance hardware, integration services and appliance development, deployment and support to allow these strategic partners to deliver "turn–key" solutions to their end–user customers.

Recent Events

On November 11, 2002, we entered into a definitive agreement to acquire TidalWire Inc. ("TidalWire"), a privately held corporation dedicated to the distribution and support of storage networking products. The acquisition will be effected through a merger of our wholly owned subsidiary into TidalWire. The merger is subject to customary closing conditions, including the approval of our stockholders and the stockholders of TidalWire. A special meeting of our stockholders is scheduled to take place on December 27, 2002 and we expect to close this acquisition as soon as practicable thereafter and after the satisfaction of the other conditions to closing, which we expect to occur by the end of December 2002. Accordingly, any forward–looking statements we make in this Annual Report on Form 10–K do not reflect the impact the acquisition of TidalWire will have on our business and operations if the acquisition is consummated.

Company Background

We were incorporated in Delaware on September 17, 1999. When we first entered the server appliance market, we focused our business primarily on providing scalable web content servers to Internet–based organizations, content infrastructure providers and larger enterprises. It was necessary for us to design most of the hardware components that went into our servers and, as a result, we

invested significant resources in the development of our products. Over time, much of the hardware components of server appliances have become commoditized and a significant number of companies have entered the server appliance marketplace.

In response to competitive pressures, combined with the effects of a downturn in the economy, we commenced a restructuring plan in the quarter ended June 30, 2001 to better align operating expenses with reduced revenues. We further undertook an extensive review of our business strategy and, in July 2001, implemented a second restructuring of our business, which de–emphasized much of our customized hardware and software development and focused our resources on what we believe to be our core competencies of hardware packaging and software integration. In addition, this restructuring of our business included a transition from primarily direct sales channels to partnerships with ISVs and OEMs in order to offer "turn–key" server appliance solutions to enterprise customers. As of September 30, 2002, we had an accumulated deficit of approximately $107.6 million.

Industry Background

Traditionally, organizations built their network infrastructure solutions with general–purpose servers. This method requires extensive time and technical resources and capabilities, which increases overall cost of ownership, including time and cost of implementation. To extend the power and features of a general–purpose server, organizations must integrate numerous discrete hardware and software elements, including operating systems, applications, security systems, load balancers and management tools, which further increases overall cost of ownership and time–to–revenue. The server appliance evolved to address these shortcomings of general–purpose servers and provide a well–designed solution to perform a single dedicated service right out of the box at a low cost of ownership. As market acceptance of server appliances continues to grow, we believe that users will increasingly demand products that meet specific functional requirements and reduce total cost of ownership and, as a result, server appliance vendors who are able to package and integrate standards–based platforms with various operating, management and application software will have a broader market opportunity.

The Network Engines Solution

We provide standards–based server appliance hardware platforms, software integration services, supply–chain management and fulfillment services that enable our strategic partners to deliver "turn–key" server appliance solutions that are easy to use, install and manage. Key elements of our solution include:

Value–Add Integration and Engineering Services. We have significant hardware and software integration skills and specialized technical resources to help our partners to expand their server appliance product offerings while reducing technical resource and support costs by providing one access point for hardware platforms, appliance and system development, deployment and support.

Supply–Chain Management and Fulfillment Services. We have extensive manufacturing and inventory management capabilities, which give us the ability to manage all of the hardware and manufacturing needs of our partners. We provide our partners with a "turn–key" solution for the hardware component of their server appliances. Once the appliance is manufactured, we can drop–ship the product to our partners' customers.

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The Network Engines Strategy

Our objective is to become a leading provider of quality server appliance hardware platforms and customized services to ISVs and OEMs. The key elements of our strategy include:

Re–focusing Product Development. During fiscal 2001, we undertook an extensive review of our operations, including our product development process. As a result, we determined that we could both lower the cost of development of our products and decrease development time through a significant increase in the usage of "off–the–shelf" or "industry–standard" components in our products. With our re–focused product development process, we believe that the integration of new "off–the–shelf" technologies into our products will improve our products' functionality, capacity and reliability and reduce development time, thereby lowering development costs.

Broadening Our Server Appliance Hardware Platforms. We believe that ISVs and OEMs will often have a specific set of requirements for creating "turn–key" appliance solutions and, as a result, there will be a need for a variety of server appliance hardware platforms and appliance development services. To increase our appeal to ISVs and OEMs, we are seeking to broaden our current line of server appliance hardware platforms to expand their technological capabilities while reducing our cost. We will purchase hardware platforms from other manufacturers both to reduce our costs and to increase the range of our product offerings.

Creating Exceptional Service and Appliance Development Support Practices. As a part of our business strategy, we assist our ISV partners to develop an appliance product through the integration of their software and our standards–based hardware platforms. The focus of our integration services is the development, execution, and completion of a comprehensive project plan, schedules and deliverables that are focused on the goal of reducing the time to market of our ISV partners' appliance solutions. Starting with the initial engagement, our project relationship extends through the product development process, general release and throughout the entire support lifecycle. Once an ISV's appliance is released, our focus shifts to provide ongoing technical, logistic and escalation management support.

Establishing Strong Brand Identity. We seek to develop market recognition as a leading supplier of hardware platforms, integration services and production capabilities for ISVs and OEMs.

Investing in Businesses, Products and Technologies. Our primary goal is to increase shareholder value. We intend to continue to pursue strategic acquisitions of, or investments in, businesses, products and technologies that will provide us with additional industry expertise, enhance our range of product offerings, expand our development and production capacity, broaden our client base, expand our geographical presence and ultimately enhance shareholder value.

Products and Services

Network Engines' Appliance Alliance Program is our approach to build high–performance server appliances for use by ISVs and leading OEM technology partners. This program enables us to combine hardware platforms, custom integration and support services with mission critical software applications to create "turn–key" server appliance solutions for enterprise customers. Creating appliance solutions allows ISVs and OEMs to take advantage of greater market opportunities, faster time to revenue and increased customer satisfaction.

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Our partners are entitled to take advantage of our product and service offerings as part of our Appliance Alliance Program. These services include:

Custom hardware platforms—We build appliances based on each Appliance Alliance member's specified configuration. Standard components are used to create unique branded appliances for each partner. Modifications to the standard platforms include the addition of unique interface devices, BIOS modifications and systems tuning.

Software pre–installation services—Our integration and engineering teams work with our partners to develop custom "images" that contain all of the software needed to create "plug and go" appliance solutions.

Software development toolkits—We have designed toolkits to enable our partners to take better advantage of our technology.

Branded bezels and packaging—As part of the services provided to our partners, we supply customized user menus, front panel displays and bezels along with custom branded packaging for their appliances.

Testing and qualification—All appliances are completely tested prior to leaving our manufacturing facility. We work closely with each of our partners to develop clear acceptance and test criteria for their appliances.

Inventory management support services—We are equipped to stock any custom hardware that our partners require. Arrangements may also be made to have appliances pre–built and stocked for immediate shipment.

Post sales support—We provide post–sales logistical support, including advance replacements, warranty and out of warranty hardware repair for our software partners.

Customers

Prior to July 31, 2001, we sold our products primarily through direct sales channels to end–users whose businesses were related to the Internet, otherwise known as "new–economy" businesses. The economic slow–down during fiscal 2001 had a drastic effect on these "new–economy" businesses, which resulted in a significant decline in our net revenues during fiscal 2001. On July 31, 2001, we began a process of re–focusing our business strategy on selling our server appliance hardware platforms and related services through indirect sales channels by forming strategic partnerships with ISVs and OEMs. As a result, our customers now include ISVs and OEMs that build server appliance solutions using our hardware platforms and services as a component of their solutions. For the year ended September 30, 2002, sales to EMC Corporation were significantly greater than 10% of our total net revenues. The loss of this customer would have a material adverse effect on our business.

Sales

Our sales organization is focused on developing strategic partnerships with ISVs who wish to offer their products as a "plug–and–go" appliance and OEMs who could sell customized hardware

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provided by us under their own label. Our regional sales managers and systems engineers work in teams to analyze our prospective ISV and OEM customers' requirements and propose server appliance or customized hardware platform solutions that meet their needs and their customers' needs. Our engineering organization provides substantial advice and assistance to our sales organization for major sales opportunities. As of November 12, 2002, we employed 10 people in sales.

Marketing

Our marketing objectives include building market awareness and acceptance of Network Engines and its products and services, as well as generating qualified customer leads. Our marketing goals include the following:

- to position us as a leader in providing server appliance hardware platforms and custom integration services;
- to plan and execute an integrated program addressing both internal and external audiences, including prospects, customers, business and trade press, industry analysts and investors;
- to design and implement media and tactical programs that communicate effectively with our target audiences; and
- to clearly and consistently communicate our positioning in marketing programs.

As of November 12, 2002, we employed four people in marketing.

Support Services

We believe that our ability to consistently provide high–quality support is a key factor in attracting and retaining ISV and OEM partners. In line with our decision to focus our core business on products for the ISV and OEM markets, we engaged a third party services company to assume the services requirements for all of our discontinued products. As a key component of our re–focused business strategy, we will provide support to our ISV and OEM partners through our customer support staff, engineering staff, manufacturing staff and sales systems engineers based in our Canton, Massachusetts facility. As of November 12, 2002, we employed two people in support services.

Manufacturing

We use a combination of in–house production and third–party suppliers to produce our server appliance hardware platforms. As of November 12, 2002, we employed 14 people in our manufacturing group. We also make use of contract employees in production and certain other areas.

Engineering

We believe that our future success depends on our ability to customize standard components and platforms acquired from third party suppliers. This customization includes both hardware and software modifications and enhancements to the standard platforms. We have assembled a team of highly skilled engineers with significant industry experience in high–density packaging, server appliance design, software, quality assurance and technical documentation. As of November 12, 2002, we employed 17 people in this group.

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Strategic Relationships

We have developed, and will continue to seek to develop, relationships with key technology vendors that enhance our product offerings. We believe the use of industry standard technologies can reduce the cost of our development activities and the cost of our products to our customers. We also believe that the integration of emerging technologies from new vendors can allow us to bring products to market more quickly and to reduce the costs that would result from developing the capability ourselves.

Competition

Our markets are highly competitive, and we expect this competition to persist and intensify in the future. We face competition primarily from server vendors that provide solutions for ISVs and build servers for the OEM marketplace.

Our principal competitors are general–purpose server manufacturers, including Dell, Hewlett–Packard, IBM and Sun Microsystems. We also compete with major distributors such as Tech Data or Bell Micro that also offer customized integration services to their customers. In addition, we compete with smaller companies that specialize in building server products, and providing some level of integration services. Examples of these competitors include SteelCloud and Advantech.

We believe that we compete favorably on factors that are important to our target market, including customized engineering capabilities, manufacturing capabilities and additional service offerings.

We expect competition in the server appliance market to increase significantly as more companies enter the market and current competitors expand their product offerings. Many of these potential competitors may have significant competitive advantages, including greater name recognition, more resources to apply to the development, marketing and sales of their products and more established sales channels.

Intellectual Property

We have invested significantly in the development of proprietary technology for our initial products and operations. We expect to have two patents issued by March 31, 2003 that will remain in effect until 2020. We believe that these patents will provide us with additional protection of proprietary information included in certain of our products. In addition, we have several patent applications pending. We have trademarks for the use of Network Engines, the Network Engines logo, ApplianceEngine 1000, ApplianceEngine 3000, ApplianceEngine 5000, and Appliance Alliance. We believe these trademarks provide us with additional protection over the use of these names and descriptions. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and control access to and distribution of our software, documentation and other proprietary information. Subsequent to the restructuring of July 31, 2001, we reduced our dependence on intellectual property and proprietary technology.

Despite our efforts to protect our proprietary rights, our competitors might independently develop similar technology and unauthorized parties may attempt to copy or otherwise obtain and use our

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products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. Due to rapid technological changes in our market, we believe the various legal protections available for our intellectual property are of limited value. In addition to such intellectual property, we seek to establish and maintain an extensive knowledge of leading technologies and to incorporate these technologies into our appliance platforms by leveraging the technological knowledge and creative skills of our personnel.

Employees

Our success in training and retaining skilled employees and, if the need arises, obtaining temporary employees during periods of increased product demand, is critical to our ability to produce high quality products on a timely basis. As of November 12, 2002, we had 57 employees. We believe that the demographics surrounding our headquarters, and our reputation and compensation package, should allow us to retain qualified employees.

We are committed to training our employees and we believe that we maintain good employee relations.

ITEM 2. PROPERTIES

Our principal business operations are conducted in our corporate headquarters in Canton, Massachusetts where we lease approximately 75,000 square feet of manufacturing and office space. Included in our leased space is 23,000 square feet of office space that we have sub–leased to a third party for the remainder of our lease term. We believe that our Canton facility will be adequate to meet our requirements for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

On or about December 3, 2001, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York against Network Engines, Lawrence A. Genovesi (our Chairman and former Chief Executive Officer), Douglas G. Bryant (our Chief Financial Officer and Vice President of Administration), and the following underwriters of our initial public offering: FleetBoston Robertson Stephens, Inc., Credit Suisse First Boston Corp., Goldman Sachs & Co., Lehman Brothers Inc. and Salomon Smith Barney, Inc. (collectively, the "Underwriter Defendants"). An amended class action complaint, captioned In re Network Engines, Inc. Initial Public Offering Securities Litigation, 01 Civ. 10894 (SAS), was filed on April 20, 2002.

The suit alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the Company's initial public offering in July 2000 ("IPO") without disclosing to investors that the Underwriter Defendants had solicited and received excessive and undisclosed commissions from certain investors. The suit also alleges that the Underwriter Defendants entered into agreements with certain customers whereby the Underwriter Defendants agreed to allocate to those customers shares of the Company's stock in the offering, in exchange for which the customers agreed to purchase additional shares of the Company's shares in the aftermarket at pre–determined prices. The suit alleges that such tie–in arrangements were designed to and did maintain, distort and/or inflate the

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price of the Company's common stock in the aftermarket. The suit further alleges that the Underwriter Defendants received undisclosed and excessive brokerage commissions and that, as a consequence, the Underwriter Defendants successfully increased investor interest in the manipulated IPO securities and increased the Underwriter Defendants' individual and collective underwritings, compensation and revenues. The suit seeks damages and certification of a plaintiff class consisting of all persons who acquired shares of Network Engines' common stock between July 13, 2000 and December 6, 2000.

In July 2002, Network Engines, Lawrence A. Genovesi and Douglas G. Bryant joined in an omnibus motion to dismiss, challenging the legal sufficiency of plaintiffs' claims. The motion was filed on behalf of hundreds of issuer and individual defendants named in similar lawsuits. Plaintiffs opposed the motion, and the Court heard oral argument on the motion in November 2002. In addition, in October 2002, Lawrence A. Genovesi and Douglas G. Bryant were dismissed from this case without prejudice.

We are unable to predict the outcome of this suit and its ultimate effect, if any, on our financial condition; however, our defense against this suit could result in the expenditure of significant financial and managerial resources.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2002.

EXECUTIVE OFFICERS OF THE COMPANY

Our executive officers, their ages and positions as of November 12, 2002 were as follows:

Name	Age	Position
John H. Curtis	60	President and Chief Executive Officer
Douglas G. Bryant	45	Vice President of Administration, Chief Financial Officer, Treasurer and Secretary
J. Donald Oldham	60	Vice President of Sales
Michael D. Riley	38	Vice President of Marketing

John H. Curtis joined Network Engines in March 2001 as President and CEO. He joined Network Engines from Artel, Inc., where he was Vice President of Worldwide Sales. Prior to Artel, Mr. Curtis served as Senior Vice President of Worldwide Operations at Banyan and was Vice President of Worldwide Sales at Intellution Inc. From 1980 to 1992, Mr. Curtis held several senior–level management positions at Stratus Computer, Inc., including Chief Operating Officer, Vice President of Finance and Vice President of International Sales.

Douglas G. Bryant has served as our Secretary and Vice President of Administration since March 2000, our Treasurer since January 1998 and our Chief Financial Officer since September 1997. Prior to joining Network Engines, Mr. Bryant served as Chief Financial Officer of CrossComm Corporation, a manufacturer of internetworking products including routers and switches, from July 1996 to June 1997, and as Corporate Controller from September 1989 to June 1996.

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J. Donald Oldham joined Network Engines in October 2002 as Vice President of Sales. Prior to joining Network Engines, Mr. Oldham was Vice President of Sales and Program Management at Manufacturers Servicers, Inc., a full–service global electronic manufacturing services and supply–chain company. From 1985 to 1998, Mr. Oldham held multiple senior management positions with Stratus Computer, including Senior Vice President of Worldwide Sales from 1994 to 1998. Mr. Oldham held a variety of sales management positions at IBM, from 1969 to 1985. Prior to IBM, Mr. Oldham was with Westinghouse.

Michael D. Riley joined Network Engines in July 2002 as Vice President of Marketing. Prior to joining Network Engines, Mr. Riley was the Chief Marketing Officer at Sonexis, Inc., a provider of collaboration solutions. Prior to Sonexis, Mr. Riley held a variety of senior management positions with Artel Video Systems from 1998 to 2001, including Senior Vice President of Marketing and Worldwide Sales and Vice President of Marketing. Prior to Artel, Mr. Riley held senior sales and marketing positions at Premisys Communications from 1994 to 1997 and Newbridge Networks Corporation from 1988 to 1993.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

(a) Market Information

Network Engines' common stock began trading on the Nasdaq National Market on July 13, 2000 under the symbol "NENG". Prior to that time there had been no market for our common stock. The following table sets forth the high and low closing sales prices per share for our common stock on the Nasdaq National Market for the period indicated:

Fiscal Year Ended September 30:	Fiscal 2002		Fiscal 2001	
	High	Low	High	Low
First Quarter	$ 1.11	$ 0.58	$ 44.00	$ 1.63
Second Quarter	1.21	0.87	3.44	0.97
Third Quarter	1.35	0.86	1.40	0.61
Fourth Quarter	1.15	0.95	0.87	0.54

(b) Holders of record

As of November 14, 2002, there were approximately 6,000 holders of record of our common stock. Because many of such shares are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

(c) Dividends

We have never paid or declared any cash dividends on its common stock. We currently intend to retain any earnings for future growth and, therefore, do not expect to pay cash dividends in the foreseeable future.

(d) Recent Sales of Unregistered Securities

Common Stock

During the fourth quarter of fiscal 2002, we did not issue any unregistered shares of our common stock.

(e) Use of Proceeds

On July 18, 2000, the Company sold 7,475,000 shares of common stock in an initial public offering at a price of $17.00 per share pursuant to a Registration Statement on Form S–1 (the "Registration Statement") (Registration No. 333–34286), which was declared effective by the Securities and Exchange Commission on July 12, 2000. The managing underwriters of the Company's initial public offering were Donaldson, Lufkin & Jenrette, Dain Rauscher Wessels, Robertson Stephens and DLJdirect Inc. The aggregate proceeds to the Company from the offering were approximately $116.9 million reflecting gross proceeds of $127.0 million net of underwriting fees of approximately $8.9 million and other offering costs of approximately $1.3 million. None of the proceeds of the offering was paid by the Company, directly or indirectly, to any director, officer or general partner of

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the Company or any of their associates, to any persons owning ten percent or more of our outstanding stock, or to any of the Company's affiliates. During the period from the offering to September 30, 2002, the Company has used the proceeds as follows: approximately $53.2 million was used to fund the operations of the Company, approximately $4.9 million was used for the purchase of property and equipment and approximately $4.3 million was used to repurchase the Company's common stock under a stock repurchase plan.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data are derived from the financial statements of Network Engines. The historical results presented are not necessarily indicative of future results. The consolidated statement of operations data for the years ended September 30, 2000, 2001 and 2002 and the consolidated balance sheet data as of September 30, 2001 and 2002 have been derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10–K. The consolidated statement of operations data for the years ended September 30, 1998 and 1999 and the consolidated balance sheet data as of September 30, 1998, 1999 and 2000 are derived from our audited consolidated financial statements not included in this Annual Report on Form 10–K. The selected consolidated financial data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Financial Statements and Supplementary Data" and the related Notes included elsewhere in this Annual Report on Form 10–K.

On November 12, 1999, Network Engines completed a three–for–one split of its common stock, which was effected through a stock dividend. On May 17, 2000, Network Engines completed a 2.5– for–1 split of its common stock, which was effected through a stock dividend. All share and per share data included in the selected financial data have been restated to reflect both of these splits.

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Selected Consolidated Financial Data
(in thousands, except per share data)

	Year ended September 30				
	1998	1999	2000	2001	2002
Net product revenues	$ 1,102	$ 6,031	$ 38,216	$ 12,850	$ 14,534
Net license revenues	—	—	4,858	665	—
Total net revenues	1,102	6,031	43,074	13,515	14,534
Cost of product revenues	1,591	4,733	26,695	12,344	12,329
Cost of license revenues	—	—	34	5	—
Cost of revenues stock compensation	—	16	254	332	147
Inventory write–down	—	—	—	20,278	—
Total cost of revenues	1,591	4,749	26,983	32,959	12,476
Gross profit (loss)	(489)	1,282	16,091	(19,444)	2,058
Operating expenses:					
Research and development	923	2,564	8,219	12,704	4,693
Selling and marketing	1,593	2,920	15,760	18,118	3,836
General and administrative	620	934	3,963	7,047	4,602
Stock compensation	—	111	2,667	5,800	4,291
Restructuring and other charges	—	—	—	10,886	353
Amortization of intangible assets	—	—	—	675	—
Total operating expenses	3,136	6,529	30,609	55,230	17,775
Loss from operations	(3,625)	(5,247)	(14,518)	(74,674)	(15,717)
Other income (expense), net	(574)	(897)	2,037	5,151	1,592
Loss before extraordinary item	(4,199)	(6,144)	(12,481)	(69,523)	(14,125)
Extraordinary gain on extinguishment of debt	—	314	—	—	—
Net loss	(4,199)	(5,830)	(12,481)	(69,523)	(14,125)
Accretion of redeemable convertible preferred stock	—	(223)	(8,103)	—	—
Net loss attributable to common stockholders	$ (4,199)	$ (6,053)	$ (20,584)	$ (69,523)	$ (14,125)
Loss per common share before extraordinary item—basic and diluted	$ (1.31)	$ (1.92)	$ (1.99)	$ (2.03)	$ (0.44)
Extraordinary item per common share—basic and diluted	—	0.09	—	—	—
Net loss per common share—basic and diluted	$ (1.31)	$ (1.83)	$ (1.99)	$ (2.03)	$ (0.44)
Shares used in computing basic and diluted net loss per common share	3,200	3,312	10,344	34,241	32,270

	September 30,				
	1998	1999	2000	2001	2002
Balance Sheet Data:					
Cash, cash equivalents, short–term investments and restricted cash	$ 113	$ 1,535	$ 112,429	$ 75,934	$ 56,196
Working capital (deficit)	(3,937)	1,897	128,332	70,873	58,612
Total assets	1,730	5,864	146,212	83,004	64,210
Long–term debt, less current portion	69	158	90	9	—
Redeemable convertible preferred stock	1,000	12,467	—	—	—
Total stockholders' equity (deficit)	4,554	(9,897)	135,476	74,489	60,876

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are a provider of server appliance hardware platforms and custom integration services. Server appliances are pre–configured computer network infrastructure devices designed to deliver specific application functionality. We are focused on partnering with independent software vendors ("ISVs") and original equipment manufacturers ("OEMs") to provide these strategic partners with server appliance hardware, integration services and appliance development, deployment and support to allow these strategic partners to deliver "turn–key" solutions to their end–user customers. When we first entered the server appliance market, we focused our business primarily on providing scalable web content servers to Internet–based organizations, content infrastructure providers and larger enterprises. It was necessary for us to design most of the hardware components that went into our servers and, as a result, we invested significant resources in the development of our products. In June 1999, we introduced the first "1U" (1.75 inch tall) server, the WebEngine Blazer. After the introduction of our WebEngine Blazer product, we experienced significant growth as we invested in the development of our technology and products, the recruitment and training of personnel for our engineering, sales and marketing and technical support departments, and the establishment of an administrative organization. As a result, our employee base grew from 39 as of June 30, 1999 to 244 as of March 31, 2001, and our operating expenses grew significantly.

Over time, much of the hardware components of server appliances became commoditized and a significant number of companies entered the server appliance marketplace. In response to competitive pressures combined with the effects of a downturn in the economy, which had a significant negative impact on our "new economy" customers, we implemented a restructuring plan in the quarter ended June 30, 2001 to better align our operating expenses with our reduced revenues. This restructuring plan resulted in a $2.8 million charge to operations in April 2001, a 73–employee reduction in our workforce, as well as the curtailment of planned facility expansion and other cost cutting measures. We further undertook an extensive review of our business strategy and, in July 2001, we implemented a second restructuring of our business, which de–emphasized much of our customized hardware and software development and focused our resources on what we believe to be our core competencies of hardware packaging, software integration and supply chain management. In addition, this restructuring of our business included a transition from primarily direct sales channels to partnerships with ISVs and OEMs in order to allow them to offer "turn–key" server appliance solutions to enterprise customers. The implementation of our July 2001 restructuring plan included a reduction in our workforce from 160 employees to 95 employees. We incurred a charge to operations of approximately $6.9 million in the quarter ended September 30, 2001 as we executed our July 2001 restructuring plan. In an effort to further streamline our operations, we reduced our workforce by 13 employees during the year ended September 30, 2002. As a result of this workforce reduction, we recorded a charge to operations of $353,000 during the year ended September 30, 2002. As of September 30, 2002, we had an accumulated deficit of approximately $107.6 million.

Our revenues are derived from sales of our server appliance hardware platforms. We recognize revenues upon shipment, provided evidence of an arrangement has been received, no obligations remain outstanding and collectibility is reasonably assured. The majority of our sales to date have been to customers in the United States.

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In the past, we generated a portion of our net revenues from license arrangements, which allowed certain customers to sell our WebEngine Blazer product under their name in exchange for per unit fees. We recognized license revenues upon the licensee's sale to its customers. We do not anticipate future revenues from license revenue arrangements.

Gross profit (loss) represents net revenues recognized less the cost of revenues. Cost of revenues includes cost of materials, manufacturing costs, manufacturing personnel expenses, obsolescence charges, packaging, license fees and shipping and warranty costs. Our gross profit (loss) is affected by the amount of our ISV revenues in relation to our OEM revenues, our product pricing and the timing, size and configuration of customer orders.

Research and development expenses consist primarily of salaries and related expenses for personnel engaged in research and development, fees paid to consultants and outside service providers, material costs for prototype and test units and other expenses related to the design, development, testing and enhancement of our products. We expense all of our research and development costs as they are incurred. We believe that a significant level of investment in product development is required to remain competitive and expect to continue to devote substantial resources to product development. However, we expect research and development expenses to decrease in absolute dollars during fiscal 2003 as we continue our transition away from the internal development of significant proprietary hardware and software. As of September 30, 2002, there were 20 employees in research and development.

Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in sales, marketing and customer support functions, as well as costs associated with advertising, trade shows, public relations and marketing materials. We expect selling and marketing expenses to increase in absolute dollars during fiscal 2003 as we expand our sales and marketing efforts to increase our market presence. As of September 30, 2002, there were 11 employees in sales, marketing and customer support.

General and administrative expenses consist primarily of salaries and other related costs for executive, finance, accounting, information technology, facilities and human resources personnel, as well as accounting, legal, other professional fees and administrative expenses associated with operating as a public company and provisions for doubtful accounts. We expect general and administrative expenses in fiscal 2003 to be comparable to fiscal 2002. There were 13 general and administrative employees as of September 30, 2002.

We recorded deferred stock compensation on our balance sheet of $15.5 million in connection with stock option and restricted stock grants to our employees and directors that were granted between February 1, 1999 and June 30, 2000. This amount represents the difference between the exercise price and the deemed fair value of our common stock for financial reporting purposes at the date of grant. We are amortizing this stock compensation over the vesting period of the related options. All options granted subsequent to June 30, 2000 have been issued with exercise prices equal to the fair market value of our common stock and, accordingly, no additional deferred compensation has been recorded. Through September 30, 2002, we amortized $7.2 million to stock compensation expense and $7.1 million of deferred stock compensation has been reversed due to the cancellation of unvested options held by terminated employees.

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We recorded $6.4 million of deferred compensation on our balance sheet as a result of restricted stock issued to the former employees of IP Performance, Inc. ("IP Performance") who were retained as our employees in connection with our acquisition of IP Performance in November 2000. The restricted stock was to vest annually through November 2003 contingent upon continued employment, resulting in $2.9 million of amortization in fiscal 2001. During fiscal 2002, we terminated the employment of all of the former IP Performance employees. In accordance with the restricted stock agreements, all of the remaining unvested restricted stock vested upon termination. As a result, during the year ended September 30, 2002, we recognized the remaining deferred stock compensation of approximately $3.5 million.

We expect quarterly stock compensation amortization of approximately $220,000 during fiscal 2003 and an aggregate of approximately $305,000 thereafter. The amount of stock compensation expense to be recorded in future periods could change if restricted stock or options for accrued but unvested compensation are forfeited.

Recent Events

On November 11, 2002, we entered into a definitive agreement to acquire TidalWire, Inc. ("TidalWire"), a privately held corporation dedicated to the distribution and support of storage networking products. The acquisition will be effected through a merger of our wholly owned subsidiary into TidalWire. The merger is subject to customary closing conditions, including the approval of our stockholders and the stockholders of TidalWire. A special meeting of our stockholders is scheduled to take place on December 27, 2002 and we expect to close this acquisition as soon as practicable thereafter and after the satisfaction of the other conditions to closing, which we expect to occur by the end of December 2002. Accordingly, any forward–looking statements we make in this Annual Report on Form 10–K do not reflect the impact the acquisition of TidalWire will have on our business and operations if the acquisition is consummated.

At September 30, 2002, we had a sub–lease agreement related to certain office space previously occupied by us (see Note 10 to our consolidated financial statements). The non–cancellable sub–lease agreement provides for the payment of approximately $747,000 of rental payments to us during the period from October 1, 2002 through March 30, 2005. On December 13, 2002, we began discussions with this sub–tenant to renegotiate the terms of the sub–lease agreement. We expect to record a charge in the first quarter of our fiscal year ending September 30, 2003 as a result of these renegotiation discussions. We do not have the ability to estimate the amount of the charge at this time.

Critical Accounting Policies And Estimates

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on–going basis, we evaluate our estimates and judgments, including those related to revenue recognition; allowance for doubtful accounts; inventory valuation; amounts which are recorded as restructuring and other charges; stock compensation expense; and income tax asset valuation. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the

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circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

We generally recognize revenue from sales of our products upon shipment to customers provided persuasive evidence of the arrangement has been received, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, title and risk of loss have passed to the customer, and all other revenue recognition criteria of SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" are met. At the time of a sale transaction, we make an assessment of the collectibility of the amount due from the customer. Revenue is only recognized at that time if we are reasonably assured that collection will occur. In making this assessment, management considers customer creditworthiness and historical payment experience. Our customers are not granted rights to return our products after the purchase has been made. However, in certain circumstances, we have accepted returns, although we were not contractually obligated to do so. We record a provision for potential returns based on our historical return rate. Material differences may result in the amount and timing of our revenue for any period if management makes judgments or uses estimates that prove to be materially different from actual experiences.

We offer a warranty on all of our products that generally provide for us to repair or replace any defective products for a period of up to 36 months after shipment. Based upon historical experience and expectation of future conditions, we reserve for the estimated costs to fulfill customer warranty obligations upon the recognition of the related revenue. To the extent we may experience increased warranty claim activity or increased costs associated with servicing those claims, our warranty reserve may need to be increased, resulting in decreased gross profits.

Allowance for Doubtful Accounts

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain an allowance for doubtful accounts based upon historical experience and any specifically identified customer collection issues. In addition, when evaluating the overall adequacy of the allowance for doubtful accounts, we also consider customer concentrations and current economic trends. While such actual bad debts recorded against the allowance for doubtful accounts have historically been within expectations and the allowance established, we cannot be sure that we will continue to be able to estimate our future experience with the same success. If the financial condition of our customers were to deteriorate, resulting in their inability to make payments, additional allowances may be required.

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Inventories

We value our inventory at the lower of cost (first–in, first–out method) or market. We regularly review inventory quantities on hand and record a reserve for excess and obsolete inventory based primarily on our estimated forecast of product demand and anticipated production requirements in the near future, giving effect to general market conditions. Any rapid technological changes and future product development could result in an increase in the amount of obsolete inventory quantities on hand. Furthermore, if our estimates of future product demand prove to be inaccurate, additional reserves may be required for incremental excess and obsolete inventory.

Restructuring and Other Charges

Involuntary termination benefits and exit costs are recognized when management approves and commits to a sufficiently detailed plan of termination or exit plan. Management must assess whether costs incurred in connection with involuntary terminations and exit activities meet certain specific requirements to be recorded and classified as restructuring and other costs. During compilation of a plan of termination or exit plan, we make certain assumptions and estimates regarding certain costs contained in these plans based on information gathered from internal and external sources. If actual results related to any of these assumptions or estimates were to exceed or not meet our expectations in the future, we may need to adjust certain restructuring and other charges in future reporting periods, resulting in increased or decreased operating expenses.

Stock Compensation

In connection with the grant of certain options and restricted stock awards to employees issued prior to our initial public offering in July 2000, we recorded deferred stock compensation within stockholders' equity of $15.5 million, representing the difference between the estimated fair value of the common stock for accounting purposes and the option exercise price of these options or restricted stock awards at the date of grant. Such amount is presented as a reduction of stockholders' equity and is being amortized over the vesting period of the applicable options. Significant judgments and estimates were involved in determining the proper valuation of deferred stock compensation because at the time of grant there was no available market for our common stock. Different assumptions would have yielded materially different results.

Income Tax Asset Valuation

We record deferred tax assets and liabilities based on the net tax effects of tax credits, operating loss carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we establish a valuation allowance. The valuation allowance is based on our estimate of future taxable income and the period over which our deferred tax assets will be recoverable. Through September 30, 2002, we believe that it is more likely than not that all of our deferred tax assets will not be realized, and, accordingly, we have recorded a valuation allowance against all of our deferred tax assets. If results of operations in the future indicate that some or all of the deferred tax assets will be recovered, the reduction of the valuation allowance will be recorded as a tax benefit during one period or over several periods.

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Results of Operations

The following data summarizes the results of our operations as a percentage of net revenues for each of the past three fiscal years. All percentage amounts were calculated using the underlying data in thousands.

	2000	2001	2002
Net product revenues	89%	95%	100%
Net license revenues	11	5	—
Total net revenues	100	100	100
Cost of product revenues	62	91	85
Cost of license revenues	—	—	—
Cost of revenues stock compensation	1	2	1
Inventory write–down	—	150	—
Total cost of revenues	63	243	86
Gross profit (loss)	37	(143)	14
Operating expenses:			
Research and development	19	94	32
Selling and marketing	37	134	26
General and administrative	9	52	32
Stock compensation	6	43	30
Restructuring and other charges	—	81	2
Amortization of intangible assets	—	5	—
Total operating expenses	71	409	122
Loss from operations	(34)	(552)	(108)
Interest and other income (expense), net	5	38	11
Net loss	(29%)	(514%)	(97%)

Years ended September 30, 2002 and 2001

Net Revenues

Net revenues increased to $14.5 million in the year ended September 30, 2002 from $13.5 million in the year ended September 30, 2001. This increase is due to higher sales volumes as a result of sales to a large OEM customer in the year ended September 30, 2002 for which there was no comparable customer during the year ended September 30, 2001. During the year ended September 30, 2002, this customer accounted for 83% of net revenues. The increase in net revenues is partially offset by a decrease in the average selling price of our products due to the high concentration of OEM revenues during the year ended September 30, 2002 as well as a decrease in license revenues during the year ended September 30, 2002. License revenues in the year ended September 30, 2002 were immaterial and we do not expect significant future license revenues.

Gross Profit (Loss)

In the year ended September 30, 2002, we had a gross profit of $2.1 million, an increase from a gross loss of $19.4 million in the year ended September 30, 2001. During the year ended September 30, 2001, we recorded a net inventory write–down of approximately $20.3 million for which there was no corresponding charge in the year ended September 30, 2002. The inventory write–down resulted

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from an unanticipated decline in sales during the year ended September 30, 2001, as well as a high level of inventory and firm inventory commitments compared to our reduced expectations for future product sales at that time. Excluding the inventory write–down and stock compensation, gross profit increased to $2.2 million, or 15.2% of net revenues, in the year ended September 30, 2002 from a gross profit of $1.2 million, or 8.6% of net revenues, in the year ended September 30, 2001. This increase was due to an increase in product sales volume, lower per unit materials costs and lower manufacturing costs, all of which occurred during the year ended September 30, 2002. The lower per unit materials cost was due to our increased use of standard off–the–shelf components in our products and a change in the mix of customer product configurations. Lower manufacturing costs were the result of the restructurings that we implemented in fiscal 2001. A decrease in license revenues during the year ended September 30, 2002 partially offset the increase in gross profit.

Operating Expenses

Research and Development. Research and development expenses decreased to $4.7 million in the year ended September 30, 2002 from $12.7 million in the year ended September 30, 2001. This decrease was due primarily to decreased compensation and recruiting costs as the number of employees in our research and development group, which was as high as 85 employees prior to our April and July 2001 restructurings, decreased to 20 employees at September 30, 2002. The decrease in research and development expenses is also due to decreases in consulting, prototype and test unit costs as we have increased the use of standard off–the–shelf components in our products, which has reduced the need to build prototype and test units and has allowed us to utilize fewer consultants in our product development process.

Selling and Marketing. Selling and marketing expenses decreased to $3.8 million in the year ended September 30, 2002 from $18.1 million in the year ended September 30, 2001. This decrease was due primarily to decreased compensation and recruiting costs as the number of employees in our sales, marketing and customer support group, which was as high as 98 employees prior to the April and July 2001 restructurings, decreased to 11 employees at September 30, 2002. The decrease was also due to a significant reduction in spending on marketing programs, as we did not attend any trade show or incur advertising expenses in the year ended September 30, 2002. To a lesser extent, decreased travel costs also contributed to the decrease in selling and marketing expenses during the year ended September 30, 2002 as a result of the decrease in sales, marketing and customer support personnel.

General and Administrative. General and administrative expenses decreased to $4.6 million in the year ended September 30, 2002 from $7.0 million in the year ended September 30, 2001. The decrease in general and administrative expenses is primarily due to lower bad debt expenses during the year ended September 30, 2002. During the year ended September 30, 2001, we recognized a significant bad debt expense as a result of the economic down–turn during that time period and the concentration of our customers in the "dot com" sector, which was significantly affected by the overall economy. The decrease in general and administrative expenses is also attributable to lower compensation and recruiting costs as the number of employees in our general and administrative group, which was as high as 34 employees prior to the April and July 2001 restructurings, decreased to 13 employees as of September 30, 2002. In addition, the decrease in general and administrative expenses

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is also due to lower consulting and professional service fees, which was somewhat offset by a charge to settle a lawsuit of less than $350,000, which was previously filed against us on December 29, 1999 by a former employee.

Stock Compensation. We recognized stock compensation expense of $4.4 million and $6.1 million in the year ended September 30, 2002 and 2001, respectively, related to the grant of options and restricted stock to employees and directors prior to our initial public offering in fiscal 2000 and in connection with restricted stock issued to employees as a result of our acquisition of IP Performance, Inc., in November 2000. The decrease in stock compensation expense in the year ended September 30, 2002 is the result of forfeitures of unvested options and restricted stock with unrecognized compensation previously held by terminated employees for which stock compensation expense is no longer being recognized. During the year ended September 30, 2002, we terminated the employment of all of the remaining employees of IP Performance, Inc. In accordance with the restricted stock agreements with these individuals, all of the related restricted stock vested upon termination and all of the remaining deferred stock compensation of $3.5 million was accelerated and recorded in the year ended September 30, 2002, which partially offset the decrease in stock compensation.

Restructuring and other charges. During the year ended September 30, 2001, we undertook two restructurings of our operations, the first of these restructurings occurred in April 2001 and the second in July 2001. In the April 2001 restructuring, we sought to better align our operating expenses with reduced revenues, and as a result of the implementation, we recorded a charge to operations of $2.8 million. This charge was due to a reduction in workforce from 243 employees to 170 employees, the curtailment of a planned expansion into leased facilities and other items. This charge included approximately $1.0 million for employee related costs including severance payments to terminated employees and stock option compensation expense related to modifications of certain stock options held by terminated employees, approximately $1.3 million to write off certain assets related to facilities that we will not be occupying and approximately $530,000 primarily related to non–refundable deposits on tradeshows we did not attend as well as costs for certain other non–cancellable sales and marketing commitments. The July 2001 restructuring was the result of an intensive review of our business, which resulted in a refocus of the sales strategy toward strategic partnerships with ISVs and OEMs and a discontinuation of much of the customized hardware and software that was previously included in our products. As a result of the implementation of the July 2001 restructuring, we recorded a charge to operations of approximately $6.9 million. This charge included approximately $1.7 million of employee related costs as we reduced our workforce by 65 employees, approximately $2.2 million as a result of our disposal of certain property and equipment, approximately $2.0 million to write off goodwill and intangible assets which were deemed to be impaired, approximately $618,000 of facility costs associated with non–cancelable operating leases for space which will not be occupied and approximately $363,000 of other charges. In addition to the April 2001 and July 2001 restructurings, in March 2001 we recorded a charge due to the retirement of fixed assets related to our WebEngine Blazer product line. These fixed assets had a total net book value of approximately $1.2 million and consisted primarily of computer equipment previously utilized in the production and sales of the WebEngine Blazer, one of our previous generation web content server appliance products. The total of the restructuring and other charges detailed above was approximately $10.9 million recorded for the year ended September 30, 2001. The reduction in our workforce implemented during the year ended September 30, 2001 impacted employees in all of our groups, including manufacturing, research and

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development, selling and marketing and general and administrative. We realized approximately $37.7 million in cost savings in fiscal 2002 as a result of our fiscal 2001 restructurings.

During the year ended September 30, 2002, we implemented an additional restructuring. In an effort to further streamline operations, we reduced our workforce by 13 employees, which impacted employees in all of our groups. The implementation of this reduction in workforce resulted in a charge of $353,000 to operations, which is comprised entirely of employee related charges, including severance payments to terminated employees. We expect to realize annualized cost savings of approximately $1.3 million as a result of this restructuring.

Amortization of Goodwill and Intangible Assets. In connection with the acquisition of IP Performance, Inc. in November 2000, we recorded goodwill and intangible assets of $2.7 million, of which we amortized $675,000 in the year ended September 30, 2001. During the year ended September 30, 2001, we completed an intensive review of our business, which resulted in the implementation of a restructuring plan. As a result of this restructuring and an assessment of expected future cash flows, we determined that the recoverability of intangible assets resulting from our purchase of IP Performance, Inc. was unlikely. Accordingly, we recognized an impairment charge in the July 2001 restructuring for the full amount of the remaining unamortized intangible assets, approximately $2.0 million, during the year ended September 30, 2001.

Interest and Other Income (Expense), net

Interest and other income (expense), net decreased to $1.6 million in the year ended September 30, 2002 from $5.2 million in the year ended September 30, 2001. This decrease was due to lower average interest rates earned on our cash equivalents and a lower average cash, cash equivalents and short–term investments balance during the year ended September 30, 2002 as a result of utilizing cash and cash equivalents to fund our net operating losses incurred since our initial public offering in July 2000.

Years ended September 30, 2001 and 2000

Net Revenues

Net revenues decreased to $13.5 million in the year ended September 30, 2001 from $43.1 million in the year ended September 30, 2000. The decrease is due primarily to a decrease in product sales volumes as a result of the general economic slowdown and its significant negative impact on the information technology spending of our "new economy" customer base. To a lesser extent, the decline in net revenues during the year ended September 30, 2001 is the result of a decrease in license revenues recognized as well as a lower average selling price of our products due to increased competitive pricing pressure.

Gross Profit (Loss)

Gross profit (loss) decreased to a loss of $19.4 million for the year ended September 30, 2001 from a profit of $16.1 million in the year ended September 30, 2000. This decrease is primarily attributable to a net charge of approximately $20.3 million to write–down excess and obsolete